DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 06-0377
Income Tax
For The Tax Years 2002-2004

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ISSUES

I. **Gross Income Tax –** Indiana Destination Sales.

Authority: IC § 6-8.1-5-1(a); IC § 6-2.1-2-2(a)(2); IC § 6-2.1-3-3; 45 IAC 1.1-3-3(d); 45 IAC 1.1-1-3; *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983).

The Taxpayer protests the assessment of tax on Indiana destination sales.

II. **Financial Institutions Tax –** Forced Combination.

Authority: IC § 6-5.5-1-17(d); IC § 6-8.1-5-1(b).

The Taxpayer contends that one of its subsidiaries is subject to the financial institutions tax rather than the adjusted gross income tax.

III. **Adjusted Gross Income Tax –** Forced Combination.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1(b).

The Taxpayer protests the forced combination for adjusted gross income tax purposes.

IV. **Tax Administration** – Underpayment Penalty.

Authority: IC § 6-3-4-4.1(d)(e).

The Taxpayer protests the imposition of the underpayment penalty.

V. **Tax Administration** – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b).

The Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

The Taxpayer is an electronic components distributor. The Taxpayer has many affiliated corporations. After an audit, the Indiana Department of Revenue (Department) assessed additional gross income tax, adjusted gross income tax, penalties, and interest. The Taxpayer protested and a hearing was held. A Letter of Findings was issued on July 25, 2007. A rehearing was requested. The rehearing was held on August 8, 2007. This Supplemental Letter of Findings results.

ISSUES

I. Gross Income Tax – Indiana Destination Sales**.**

DISCUSSION

The Taxpayer paid gross income tax on the income from some of its sales to Indiana customers. The Department found that all of the Taxpayer's sales to Indiana customers were subject to gross income tax and assessed additional gross income tax accordingly. The Taxpayer protested the additional assessment. The Taxpayer contended that the Department assessed income tax on exempt income derived from sales in interstate commerce.

Tax assessments are presumed to be accurate. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.* All exemptions are to be strictly construed against the Taxpayer. *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983).

During the tax period, Indiana imposed a gross income tax on that portion of a non-resident's income that was "derived from activities or businesses or any other sources within Indiana." IC § 6-2.1-2-2(a)(2). There was an exemption from the gross income tax found at IC § 6-2.1-3-3 as follows:

> Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution.

The Taxpayer argued that a portion of its Indiana income was derived from interstate commerce and therefore qualified for the interstate commerce exemption.

In order to avoid offending the Interstate Commerce Clause, gross income tax assessments must meet the requirements found at 45 IAC 1.1-3-3(d) as follows in relevant part:

> Gross income derived from the sale of tangible personal property in interstate commerce is subject to the gross income tax if the sale is

> completed in Indiana. The following examples are situations where a sale is completed in Indiana prior to or after shipment in interstate commerce:
> . . .
> (7) A sale to an Indiana buyer by a nonresident seller if the sale:
> (A) originated from;
> (B) was channeled through; or
> (C) was otherwise connected with;
> an Indiana business situs established by the seller.

The definition of "a business situs" is clarified at 45 IAC 1.1-1-3 as follows:

> (a) A "business situs" arises where possession and control of a property right have been localized in some business or investment activity away from the owner's domicile.
> (b) A taxpayer may establish a business situs in ways, including, but not limited to, the following: [agency route, or other place where the taxpayer's affairs are conducted.]
> (1) Use, occupancy, or operation of an office, shop, construction site, store, warehouse, factory, agency route, or other place where the taxpayer's affairs are conducted.
> (2) Performance of services.
> (3) Maintenance of an inventory or stocks of goods for sale, distribution or manufacture.
> (4) Sale or distribution of merchandise from company-owned vehicles where title to the goods passes at the time of sale or distribution.
> (5) Acceptance of orders without the right of approval or rejection in another state.
> (6) Ownership, leasing, rental, or other business activities connected with income-producing property (real or personal).
> (7) Ownership (in whole or in part) of a partnership doing business in Indiana unless the ownership is that of a limited partner who does not participate in the control of the business.
> (8) Other business or investment activities, other than de minimis, performed on behalf of the taxpayer by an employee of the taxpayer. These activities shall be considered together, not in isolation, in deciding if they are de minimis.

The Taxpayer maintained an office and warehouse in Indiana during 2002 and a portion of 2003. These locations established an Indiana situs for the Taxpayer. The issue is whether or not the sales on which gross income taxes were assessed originated from, were channeled through, or were associated with the Taxpayer's Indiana situs.

In order for the Department to properly evaluate the Taxpayer's sales, the Department requires the Taxpayer to properly describe and document its actual sales. The Taxpayer

submitted the following formula and method of calucation to show how it arrived at the income from sales it considered taxable because they were channeled through an Indiana situs.

1. The ratio of *Indiana sales* per financial statements to invoicing system is computed, resulting in a ratio of 1.00063812624.
2. The foregoing ratio is then applied to the $8,864,422 *Indiana destination sales originating from the Indiana branch* to approximate the same Indiana sales per financial statement purposes - $8,870,079 (rounded up).
3. That amount is then subtracted from the $33,230,401 in Indiana destination sales per financial statements to get to non-taxable Indiana sales (i.e., *Indiana sales that do not have an Indiana tax situs*) - $23,360,322.

The handwritten computation at the bottom of Exhibit C further reconciles to what was reported on the Indiana return:

1. Total sales include the $33,230,401 in *Indiana sales* per financial statements, plus its 1[percent] share of *Indiana sales* made by [Taxpayer], or $103,180, resulting in a total of $33,333,581.
2. Nontaxable sales in the amount of $23,360,322, from the reconciliation computation discussed above, were subtracted along with the $1,000 exemption, resulting in taxable *Indiana sales*, per return, in the amount of $8,972,259. (*Emphasis added*)

Acceptance of this formula and mathematical computation presupposes that the Taxpayer properly determined which sales were taxable. The Taxpayer did not submit any invoices, contracts, or other documentation to demonstrate how it determined which sales were associated with an Indiana office and which sales originated in another state and were drop shipped to the Indiana customer. Without documentation about the actual sales, there is no information from which to determine which sales qualified as taxable Indiana destination sales. The Department is unable to accept the Taxpayer's unsubstantiated conclusions of which sales were not Indiana destination sales and therefore exempt from the tax.

In the second hearing, the Taxpayer resubmitted charts to substantiate its claim that the Department assessed gross income tax on sales that were not connected with its Indiana operations. These charts, which were also submitted at the first hearing, were prepared by the Taxpayer and are merely conclusions based upon Taxpayer's records. No primary documents were offered.

Neither the Taxpayer's calculation methodology nor the charts are adequate to sustain the Taxpayer's burden of proving that the Department erred in its determination of the Taxpayer's income derived from taxable Indiana destination sales.

FINDING

The Taxpayer's protest is respectfully denied.

II. Financial Institutions Tax – Forced Combination.

DISCUSSION

The Taxpayer sells tangible personal property to a customer. The Taxpayer invoices the customer for the item. The customer has a period of time, such as thirty days, to pay the cost of the item to the Taxpayer. At the time of the sale, the Taxpayer enters the money to be received from the sale on its books. The Taxpayer has created an account receivable. The Taxpayer then sells these accounts receivable at a steep discount to Corporation F for collection. Corporation F borrowed money using the accounts receivable as securitization for commercial paper in the short term market. The yield on the commercial paper was considered a financing cost and included an interest expense in the consolidated statement of operations. Corporation F loaned funds to the Taxpayer as an offsetting asset.

The Taxpayer argued that Corporation F was a financial institution because it engaged in the acquiring, servicing, and selling of loans or extensions of credit – the accounts receivable – which Corporation F purchased from the Taxpayer. The issue is whether or not accounts receivables are loans or extensions of credit as contemplated by the statute.

The Taxpayer submitted a Revenue Ruling issued August 1, 2001, in support of its contention that the income of Corporation F, a "factoring corporation," is subject to the financial institutions tax. It is not clear, however, that the facts in that situation are identical to the Taxpayer's situation. Further, the Revenue Ruling is over six years old. Therefore, it no longer has precedential value. The Taxpayer's situation must be considered on its own merits.

To be considered a financial institution subject to the financial institution's tax, Corporation F must receive at least eighty percent of its gross income from one of the activities listed at IC § 6-5.5-1-17(d) as follows:

> (2) For any other corporation described in subsection (a)(4), all of the corporation's business activities if eighty percent (80 [percent]) or more of the corporation's gross income, excluding extraordinary income, is derived from one (1) or more of the following activities:
>
> (A) Making, acquiring, selling, or servicing loans or extensions of credit. For the purpose of this subdivision, loans and extensions of credit include:
> - (i) secured or unsecured consumer loans;
> - (ii) installment obligations;
> - (iii) mortgage or other secured loans on real estate or tangible personal property;
> - (iv) credit card loans;

(v) secured and unsecured commercial loans of any type;
(vi) letters of credit and acceptance of drafts;
(vii) loans arising in factoring; and
(viii) any other transactions with a comparable economic effect.

(B) Leasing or acting as an agent, broker, or advisor in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes.

(C) Operating a credit card, debit card, charge card, or similar business.

As used in this subdivision, "gross income" includes income from interest, fees, penalties, a market discount or other type of discount, rental income, the gain on a sale of intangible or other property evidencing a loan or extension of credit, and dividends or other income received as a means of furthering the activities set out in this subdivision.

The Taxpayer's accounts receivable do not amount to a loan or extension of credit. The Taxpayer does not loan money to customers or service loans. The Taxpayer does not sell and service investment vehicles. The Taxpayer does not provide mortgages. The Taxpayer does not offer and service extensions of credit such as limits up to which a customer can borrow money without prior approval. The Taxpayer does not offer and service credit cards. Neither the Taxpayer nor Corporation A retains title to the property delivered to customers until total payment is received. There are no loan documents which specify regular payments of principal and interest. The Taxpayer merely sets up typical accounts receivable – essentially thirty day grace periods – before payment for a good or service is due. Corporation F purchases the Taxpayer's accounts receivable at a discount and collects them. This activity does not constitute transacting financial business subject to the financial institutions tax.

In the Taxpayer's accounts receivable, the customer has a debt which it owes to the Taxpayer for the purchase of a certain item. If it were a consumer or commercial loan, the Taxpayer would have given the customer money or a credit to purchase items. Neither the Taxpayer nor Corporation F hold a security interest in the property. The accounts receivable established by the Taxpayer are not governed by truth-in-lending statutes and regulations as consumer loans are. The Taxpayer is not loaning money to its customers. Rather, the Taxpayer is delivering product to its customers and then allowing a short grace period before payment for the product is due. This does not constitute an unsecured consumer or commercial loan. Since there is no loan to the customer, there is no loan arising in factoring.

The Taxpayer also argued that Corporation F qualified as a financial institution because it borrowed money in the open market and loaned that money to the affiliated corporations. In reality, however, Corporation F merely passed the money it borrowed through to the

affiliated corporations. Corporation F did not make actual loans to the other affiliated corporations. Corporation F did not service the nonexistent loans.

Corporation F does not receive at least eighty percent of its income from any of the transactions enumerated in IC § 6-5.5-1-17(d). Therefore, Corporation F is subject to adjusted gross income tax rather than financial institutions tax.

FINDING

The Taxpayer's protest is respectfully denied.

III. Adjusted Gross Income Tax – Forced Combination.

DISCUSSION

Since all of the corporations were subject to the adjusted gross income tax, the issue is whether the Department properly combined the corporations. The Department determined that the Taxpayer should have been combined with several corporate affiliates, "F," "MN," "IL," and "E." Corporation E is identified as the Taxpayer after September 2003. Corporation E will therefore be denominated the "Taxpayer."

Corporation F was incorporated in the process of a three year Accounts Receivable Securitization financing. Corporation F was formed during the fiscal years ending 3/31/2002 and 3/31/2003. In 2003, Corporation F transferred its accounts to the parent corporation, the Taxpayer. Corporation F was then dissolved. During its operation, Corporation F purchased accounts receivable from the other related corporations.

The Taxpayer argues that the Department has the burden of proving that it properly combined the corporations for adjusted gross income tax purposes. The Taxpayer errs. Taxpayers have the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c).

The Department combined the Taxpayer and its related corporations into combined Indiana returns for the tax period 2001 - 2003 pursuant to the provisions of IC § 6-3-2-2 as follows:

> (l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any of the taxpayer's business activity, if reasonable:
>
> (1) separate accounting:
> (2) the exclusion of any one (1) or more of the factors:
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

> (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

When a taxpayer's method of filing individual Indiana adjusted gross income tax returns for related corporations does not accurately reflect the Indiana income or expenses, the Department is allowed to require that the related taxpayers file a combined return. The purpose of the forced combined return would be to fairly reflect the taxpayer and related corporations' actual Indiana income and expenses.

In this case, the Taxpayer's filing method distorted the Taxpayer's Indiana income and expenses. By selling its accounts receivable at a discount, the Taxpayer created a substantial artificial loss unrelated to its Indiana business activities. This artificial loss distorted the Taxpayer's Indiana income and expenses reported on the Taxpayer's individual Indiana adjusted gross income tax return. Corporation Z's loans to the affiliated corporations and associated interest expense deductions also distorted the Taxpayer's Indiana adjusted gross income. Due to these distortions, the Indiana adjusted gross income tax return did not fairly reflect the Taxpayer's Indiana income. The Department was justified in forcing the related corporations to file a combined return in order to fairly reflect the Taxpayer's Indiana income. The Taxpayer has not met its burden of demonstrating that the Department erred by requiring the filing of combined returns.

FINDING

The Taxpayer's protest is respectfully denied.

IV. Tax Administration – Underpayment Penalty**.**

DISCUSSION

A corporation subject to the adjusted gross income tax is required to report and pay the estimated tax equal to twenty-five percent – as the corporation's estimated adjusted gross income tax liability for the taxable year. IC § 6-3-4-4.1(d). If the Taxpayer does not pay an estimated tax equal to twenty – five percent of its total estimated tax liability, then the Department will assess a ten percent underpayment penalty unless the payment is equal to either twenty percent of its final actual tax liability for the current year, or it is equal to twenty – five percent of the previous year's final actual tax liability. IC 6-3-4-4.1(e). In this case the Department determined that the Taxpayer underpaid its estimated Indiana adjusted gross income tax liability.

FINDING

The Taxpayer's protest is respectfully denied.

V. Tax Administration – Negligence Penalty.

DISCUSSION

The Taxpayer protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
>
> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer failed to follow the Department's long established instructions concerning the payment of gross income tax on Indiana destination sales. This breach of its duty

constituted negligence. The penalty was properly imposed.

The Taxpayer also argued that penalties are not cumulative and the Department can only assess one penalty. There is no statutory support for this position. The Department assessed each penalty as a result of specific and distinct circumstances pursuant to the law.

Finding

The Taxpayer's protest to the imposition of penalty is respectfully denied.

KMA/LS/DK – September 28, 2007